MINUTES
of the
FOURTH MEETING
of the
RETIREMENT SYSTEMS SOLVENCY TASK FORCE

September 10, 2010
Room 307, State Capitol
Santa Fe

The fourth meeting of the Retirement Systems Solvency Task Force (RSSTF) was called to order by Representative Mimi Stewart, co-chair, on September 10, 2010 at 9:02 a.m.

Present
Rep. Mimi Stewart, Co-Chair
Mr. Tito Chavez, Co-Chair
Mr. Diego Arencon
Mr. Oscar Arevalo
Mr. Charles Bowyer
Ms. Jan Goodwin
Mr. H. Russell Goff
Sen. Phil A. Griego
Rep. John A. Heaton
Mr. David Heshley
Ms. Emily Kane
Ms. Alexis Lotero
Sen. Steven P. Neville
Mr. Andrew Padilla
Mr. Wayne Propst
Mr. Terry Slattery
Rep. Thomas C. Taylor
Ms. Christine Trujillo
Mr. Jeff Varela
Rep. Luciano "Lucky" Varela

Absent
Sen. Pete Campos
Mr. Bill Fulginiti
Ms. Michelle Lewis
Mr. Ronald Sanchez
Sen. John Arthur Smith

Guest Legislator
Rep. Miguel P. Garcia

Staff
Raúl E. Burciaga, Director, Legislative Council Service (LCS)
Tom Pollard, LCS
Doris Faust, LCS
Claudia Armijo, LCS

Guests

The guest list is located in the meeting file.

Handouts

Handouts and other written testimony are in the meeting file.

<u>Friday, September 10</u>

Representative Stewart welcomed the RSSTF and guests to the meeting. She noted that those members present would begin operating as a subcommittee. She reminded the members that the meeting was being audio webcast and asked them to introduce themselves prior to speaking and turn their microphones on and off before and after speaking. Next, Representative Stewart asked the presenters from Buck Consultants to introduce themselves. Buck Consultants is the actuarial services company hired by the RSSTF to assist it with issues before the task force. David Slishinsky, principal and consulting actuary of Buck Consultants, introduced himself and told the members that he has 35 years of actuary experience, more than 20 of them at Buck Consultants. He said he specializes in public sector work and is the sole actuary for the states of South Dakota, Nebraska and Alaska. Michelle DeLange, director of retirement for Buck Consultants, introduced herself and told the members that she has been working at Buck Consultants for five years and that she specializes in public sector clients.

Overview of the Actuarial Process, the Problems Facing the Public Employees Retirement Association (PERA) and the Educational Retirement Board (ERB) — a Preliminary Evaluation of the Nature and the Scope of Concerns and Timing Issues: The Effect of Time Frame Decisions in Corrective Actions to Pension Plans

Mr. Slishinsky started the presentation by explaining what he and Ms. DeLange would be discussing. He asked Representative Stewart if they could take a few minutes for task force members to let Buck Consultants know what kind of information the members would like to hear about at the meeting. Representative Stewart asked for an objective review of what the State of New Mexico's retirement systems are facing. She specifically indicated a need to determine if the PERA and the ERB are "safe and secure". She noted that some of the RSSTF members are eager to make changes to the pension plans right away, while others believe that the retirement funds typically fluctuate, going up and down in value over time. She asked the representatives from Buck Consultants to provide suggestions of what, if anything, the state might consider doing regarding its pension plans.

The members had a general discussion involving what information they would like to receive or learn more about. They were interested in the consultants' thoughts regarding what would happen to the state's pension funds if no changes are made to the plans. Members asked if the consultants think that, over time, the plans would "self-correct". Some members said that they have received calls from retirees who have read newspaper articles or heard rumors regarding the pension plans and want to know what the legislators are planning to do. Task force members noted that employees want to know specifically about changes that might affect their contribution rates and their vesting eligibility. Members mentioned that retirees and employees alike are experiencing anxiety over the perceived uncertainty surrounding the pension funds. Representative Stewart took a moment to advise the members and the audience that the presentation handout provided by Buck Consultants would be posted on the New Mexico Legislature web site, and the web site would include information regarding how to get a copy.

Mr. Slishinsky directed the members' attention to the handout and noted that he would begin presenting an overview of the actuary process, the steps involved and the topics covered. He said actuaries are professionals trained in mathematics. He said they must go through a stringent examination process. He added that actuaries focus on probability and statistics, compound interest, business and finance. Actuaries' training includes college education, on-the-job training and examinations conducted by professional organizations, such as the Society of Actuaries and the Joint Board of Enrolled Actuaries. Mr. Slishinsky continued with an overview of the types of work actuaries can perform, and he gave examples of the types of clients for whom they might provide services. He specifically mentioned that actuaries working for retirement systems analyze a wide range of variables, including contribution rates, funding periods, funding status and projections of liabilities, contribution rates and funding periods. He noted that state pension plans need to determine contribution rates, as well as target rates of returns on investments necessary for the plans to meet their liabilities.

Next, Mr. Slishinsky talked about pension plan valuation. The valuation is a snapshot in time, providing a picture of the status of the plan at any given point in time. The size of the promise must be compared against the plan's assets, and the actuary must determine how much the benefits will cost. Mr. Slishinsky told the members that the Governmental Accounting Standards Board (GASB) requires the valuation of pension plans for reporting purposes. The valuations are performed annually, and the calculations are performed on each member in the plan. The information is produced by the actuaries using model software. The end product is a valuation of the pension plan at a specific point in time, and the software used can also assist the actuary in providing projections of a plan's future value.

According to Mr. Slishinsky, there is a basic retirement funding equation: C+I=B+E, meaning "contributions plus investment income equals benefits and expenses". The equation must be viewed with an eye toward the long term. He noted that contributions are determined by funding policies.

Mr. Slishinsky continued by explaining that the population data used in the valuation include detailed information about each member, including the member's date of birth, age, salary, plan code, gender, contribution amounts, beneficiaries and form of benefit. He emphasized that as long as a pension plan can meet its amortization rate and meet its payments, the plan's fund is considered sound.

Ms. DeLange described the components of a pension plan's provisions. She said they include how much, when and to whom a benefit can be paid. She said that the PERA benefit summary for state general employees is a benefit of 3% of an employee's highest consecutive 36-month salary multiplied by the employee's years of service. She said that the PERA does not provide early retirement benefits. The PERA provides employees with a 3% cost-of-living adjustment (COLA), effective only after the employee has been retired for two years.

Next, Ms. DeLange explained the ERB benefits. She said that the ERB provides a benefit of 2.35% of the employee's final five-year average salary multiplied by the employee's number of years of service and provides for a COLA amounting to one-half the increase in the cost-of-living increase with a minimum of 2% and a maximum of 4%.

Ms. DeLange discussed the PERA and the ERB respective funds' assets, focusing on how each fund's assets are allocated. She also discussed how pension plans are valued and explained that the value of a fund is not typically determined according to the market value of the fund's assets. In other words, the market value of a plan's assets is simply the amount for which it could be sold at the time the valuation is made. Rather than using this measure, public pension fund actuaries use a valuation concept called "actuarial assets" and involves "smoothing" returns from year to year to reduce measured volatility of plan funding. Most plans smooth returns over five years, meaning that a particularly high or low return in one year will not be fully incorporated into the measure of actuarial assets for another five years. The use of market value is avoided because it can produce volatile contribution rates. Smoothing reduces the plan's value volatility. The market value of the PERA funds as of June 30, 2009 was $8,781 million, and the market value of the ERB funds was $7,113.7 million. By contrast, the smoothed actuarial value of the PERA funds as of June 30, 2009 was $12,554 million, and the ERB fund's smoothed actuarial value was $9,366 million. Ms. DeLange noted that actuarial values are expected to be below market values when the stock market is performing well and above market value when the stock market is performing poorly.

Mr. Slishinsky next provided information regarding liability and normal cost calculations. He noted that pursuant to the GASB, there are six different methods acceptable in calculating the cost of benefits. He talked about the terminology used in the actuarial field and explained the difference between aggressive and conservative assumptions. He said the actuary uses personal judgment in determining whether to apply aggressive assumptions that will produce a smaller present value or conservative assumptions that will produce a larger present value.

Referring to the handout, Mr. Slishinsky used graphs to illustrate methods to depict fund benefits and liabilities. He explained that investment earnings represent the single greatest impact on the value of a fund. He told the members that some of the causes of unfunded actuarial liabilities are: granting initial benefits or benefits increases for services already rendered; actuarial experience that is less favorable than assumed; and contributions that differ from actuarially calculated amounts.

Ms. DeLange spoke to the members about pension plan contribution rates and funding periods. She explained that "normal costs" are costs expected to occur during one year and the value of a given year's expected benefit accruals. She said the funding period is defined as the period of time it will take to pay the unfunded liability at the plan's statutory contribution rates.

Pursuant to the GASB, the standard funding period for pension plans is 30 years. However, there are proposed changes that would reduce the standard funding period. She noted that in order to maintain a 30-year funding period, a number of states are increasing plan contribution rates. When asked how work force reductions might affect the funding period, Ms. DeLange responded that without growth in the payroll amounts, there will be less money contributed to the fund and the funding period would consequently increase.

Next, Mr. Slishinsky opined that the PERA fund is "better off than most states". He stressed that recent economic markets have negatively affected most pension plans. He noted that according to the 2010 Wilshire Survey Report, the average funded ratio for pension plans declined substantially between 2008 and 2009. According to the survey, the PERA's and the ERB's actuarial values experienced less of a decline in funding ratio than the survey average. For example, in 2009, the average pension fund in the survey was funded at 72%, whereas the PERA was funded at 84%. However, although its rate of decline was less than the survey average, the ERB was funded at 68% for that same year, below the survey average of 72%.

Mr. Slishinsky said that recently, both the PERA's and the ERB's investments have produced returns better than the national average. He noted, however, that the PERA had a two-year period of negative returns from 2007 to 2009, and he said it is very important for the fund to beat its assumption rate of return. The rate of return for the PERA is 8%.

Mr. Slishinsky explained that a pension plan's funding status is a product of its actuarial assets divided by its accrued liabilities, and he graphically illustrated the PERA's and the ERB's respective historical funding status. Both funds showed unfunded liabilities in 2009. He followed with a discussion about the risk associated with various public pension funds versus their assumed real rates of return. He highlighted the information in the handout regarding "debt transfer". Debt transfer measures the amount that future taxpayers are committed to pay for past employee service benefits. The debt transfer for the PERA is 113% and for the ERB it is 175%. He noted that the debt transfer measurement is a required reporting item pursuant to the GASB. He also discussed the term "liquidity", which refers to the measure of a fund's market value divided by its benefit payments. Liquidity measures the approximate number of years of benefit payments that the fund's market value assets can cover without the fund getting future contributions. The trend toward liquidity in a fund is an indication of the fund's solvency risk, and, according to Mr. Slishinsky, a fund's period of liquidity should be between 10 and 15 years. He noted that the PERA's liquidity period is estimated to be 13.8 years, while the ERB's liquidity period is estimated to be 11 years.

Mr. Slishinsky next talked about the projected funded ratio status of both the PERA and the ERB plans through 2019. He used graphs to illustrate the unfunded liability of each fund, assuming an 8% rate of return on investments for both funds. The graphic depiction did not include assumptions resulting from the recent statutory changes applying to the state's new hires. Mr. Slishinsky said that because the changes apply only to new employees, the impact would not be significant for the purposes of the graphs in the handout. According to the information generated by Buck Consultants, the PERA fund will be 62% funded through 2019 and the ERB fund will be 60% funded. Buck Consultants projects fluctuations in the funding percentages for the ERB, with only a 57% projected funded ratio in 2013.

Mr. Slishinsky offered the following conclusions regarding the PERA and the ERB pension funds:

1) Without changes in contributions or without a significant stock market return on investments, the funds' respective funding ratios are expected to decline over the next 10 years.
2) Short-term funded ratios will be highly dependent on actual investment returns.
3) Benefit and funding policy changes are needed.

Mr. Slishinsky said that most states have an "ideal" goal of pre-funding with a funding ratio of 100%.

With respect to the effect of timing decisions related to corrective actions taken toward pension plans, Mr. Slishinsky said that changes to defined benefit plans that apply only to new members take a long time to realize significant changes to the plan. Among the potential changes that will not affect a pension fund immediately are:

1) implementing a later retirement age;
2) increasing the final average salary period;
3) lowering the COLA;
4) lowering the multipliers;
5) implementing a longer vesting period; and
6) early retirement reductions.

Again, he noted that the most significant and immediate impact on a pension plan fund is its return on investments. He further noted that New Mexico's pension plans should be monitored frequently and continually. He added that any changes to a plan's benefits should be based on the state's commitment for adequate benefit coverage and not necessarily based upon that state's funding policy.

Mr. Slishinsky talked briefly about the changes that might be expected as a consequence of New Mexico's recent benefit plan changes, specifically, the benefit changes for the new tier of employees. He said that there will be a long period of elapsed time before any savings resulting from the changes will be realized.

Pension Reform Options That Provide the Greatest Opportunity for Solvency

Mr. Slishinsky and Ms. DeLange stressed to the members that the greatest impact would continue to be investment returns. They told the members about changes made to pension plans in other states in 2010. Some of those changes include:

1) moving to a defined contribution or hybrid plan;
2) increasing employee eligibility for normal or early retirement;
3) increasing the period for the final average salary calculation;
4) increasing the service years requirement for vesting;
5) formula multiplier changes; and

6) reducing or limiting plan COLAs.

Mr. Slishinsky noted that there are states that are making changes to the benefits of current members. He added that those states are facing lawsuits as a result of the changes. There was a discussion among the members and the presenters regarding the potential for such lawsuits. It was generally agreed that the lawsuits are most likely to materialize if a state changes the benefits of members who are vested in their plans. But, even members who have not yet vested could bring suit. The state's ability to defend a suit successfully involving changes to its pension plan benefits will depend on many varied factors, including a state's statutes and its constitution. States currently facing litigation resulting from changes to pension plan benefits are Colorado, South Dakota and Minnesota.

There was next a discussion about changes to a pension plan's COLA. It was noted that a number of states are making changes and others are considering changes. Many systems are instituting maximum adjustments, and many are tying any COLA increases to the Consumer Price Index. It was noted that changes made to pension plan COLA provisions can have significant compounded savings. For example, a 1% decrease in the COLA could reduce a pension plan's normal cost rate by 8% to 12%.

Mr. Slishinsky explained that a number of states are changing their plans' retirement eligibility. In all of those states, the changes will apply only to new employees hired after the effective date of the change. States are considering changes to the minimum retirement age. Part of the reason for this consideration is the fact that employees are living longer and, therefore, enjoying longer retirements.

Formula multiplier changes will affect the funding rate of a fund. Such changes produce a direct impact and can reduce the benefits and ongoing costs to the fund by a proportional amount of a downward reduction. An obvious consideration is the fact that new plan members will understand that they are earning a lesser benefit while contributing at the same rate as members that are not new hires. Other states are considering changing their calculations for final earnings. Arizona, Illinois, New Jersey and Virginia are all changing their final average earnings calculations for new members only, while Iowa is changing it for all plan members.

Changing the contribution rates presents a significant way for a plan to reduce its unfunded liability because increased contributions immediately affect the amount of the unfunded liability. However, it was noted that increases in contributions for members participating in social security could become burdensome. The PERA's contribution rates for general employees are 15.09% for employers and 8.92% for members. According to Buck Consultants, in FY 2012, the rates will be 16.59% for employers and 7.42% for employees. The ERB contribution rates are 10.9% for the employers, increasing to 13.90% in FY 2012, and 9.40% for members, decreasing to 7.9% in FY 2012. Mr. Slishinsky noted that if the PERA increases its contribution rates by 1% in FY 2012 for both the employers and the members, its funding ratio would be 65% by FY 2019. The same increases applied to the ERB plan would see that plan's funding ratio increase to 63% in FY 2019. A number of states are changing both their members' and their employers' contribution rates.

Other options presented by Mr. Slishinsky and Ms. DeLange include early retirement reduction factors. They noted that increasing early retirement reductions can decrease the plan's normal costs rate by up to 7%. Changes to vesting requirements can affect the pension plan. Both the PERA and the ERB have five-year vesting periods. Changing to 10-year vesting periods would affect the normal cost rate by 3% to 5%, depending on the demographics.

In conclusion, Mr. Slishinsky and Ms. DeLange apprised the members of a number of points:

1) changing benefits under a new tier and implementing contribution increases will improve long-term funding but will occur slowly;

2) benefit reductions for current members would have a significant impact on funding but would lead to legal challenges;

3) the funds' respective investment returns in both the short term and the long term will ultimately determine costs and will have a significant impact on contribution rates and funding periods; and

4) New Mexico should continue to monitor the funds for progress.

There began a long discussion regarding the definition of "solvency". Members questioned Mr. Slishinsky and Ms. DeLange in an effort to have them opine as to whether the PERA and the ERB are "solvent". Mr. Slishinsky declined to make such a determination. He said that the actuaries make calculations and handle the assumptions, but they leave the hard questions like solvency to the legislators. As the discussion progressed, it continued to return to the issue of solvency and what it means, particularly for New Mexico's pension funds. Members talked about changes to the pension plans that could encourage good behavior and professional incentives. Members talked about the idea of the PERA and the ERB boards going to their respective members and getting an understanding of what the members would accept in the way of changes. The question regarding the definition of "solvency", specifically as it applies to the PERA and the ERB, continued to arise. Members stated their agreement that they need to define the term.

Representative Stewart asked the members to consider all of the information presented at the meeting along with past meeting information and to email proposals for the PERA and the ERB pension plans changes to Mr. Burciaga. She noted that the members should try to develop a list of changes they could support. The members were assured that their proposals for changes would remain anonymous. Representative Stewart requested that Mr. Burciaga and his staff then compile the information into a format useful for discussions by the members at the October RSSTF meeting.

With no further business, the meeting was adjourned at 4:20 p.m.